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In the Supreme Court

OF THE
United States

OCTOBER TERM, 1944

No. **1305** 85

LORIN A. CRANSON,

Petitioner,

VS.

THE UNITED STATES OF AMERICA,

Respondent.

PETITION FOR WRIT OF CERTIORARI
to the United States Circuit Court of Appeals
for the Ninth Circuit
and
BRIEF IN SUPPORT THEREOF.

LEON DE FREMERY,
Crocker Building, San Francisco 4, California,
Attorney for Petitioner.



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PETITION FOR WRIT OF CERTIORARI
to the United States Circuit Court of Appeals
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*To the Honorable Harlan Fiske Stone, Chief Justice
of the United States, and to the Honorable Asso-
ciate Justices of the Supreme Court of the United
States of America:*

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Ninth Circuit entered January 24, 1945, rehearing denied February 26, 1945 (R. 76), which affirmed the judgment of the United States

District Court for the Northern District of California, Southern Division, entered October 25, 1943. (R. 62.)

OPINION BELOW.

The opinion of the Court below, filed January 24, 1945, is reported at 146 F. (2d) 871, and a copy will also be found in the printed Transcript of Record at pages 71 to 74. No opinion was rendered by the District Court.

BASIS OF JURISDICTION.

The jurisdiction of this Court is invoked under section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925, 43 Stat. 938. (Appendix, p. i.)

The judgment of the Circuit Court of Appeals for the Ninth Circuit was filed January 24, 1945 (R. 75); petition for rehearing was filed February 20, 1945, and denied on February 26, 1945. (R. 76.)

SUMMARY STATEMENT.

This is a test case brought on behalf of all stockholders of Honolulu Oil Corporation for the purpose of determining the taxability of dividends declared by that corporation during the calendar year 1936. Two companion test cases, which will be controlled by the disposition of this case, have been filed to deter-

mine the taxability of dividends declared during the calendar years 1937 and 1938.

All three cases involve the same fundamental question of law which may be generally stated as follows: Where a corporation undertakes a new venture through the formation of a wholly owned subsidiary corporation, and the subsidiary is operated at a loss and is thereafter liquidated and dissolved, do the earnings of the parent corporation available for dividends remain forever undiminished by this unprofitable venture, with the result that distributions which are admittedly returns of capital are taxed to the stockholders as income?

The facts with respect to this petition are that petitioner received during the calendar year 1936 dividends from Honolulu Oil Corporation in the sum of \$450.00 and reported the full amount thereof as subject to income tax. (R. 28-29.) Thereafter petitioner filed claims for refund based on the ground that \$432.00 of said dividends were not paid out of earnings or profits and were not taxable to petitioner. (R. 29-30.) After the disallowance of said claims (R. 30), suit was filed in the District Court and the case was tried upon stipulated facts, the essential facts being as follows:

Honolulu Consolidated Oil Company was incorporated in 1910 under the laws of the State of California. In 1930 it was reincorporated under the laws of the State of Delaware as Honolulu Oil Corporation, Ltd. In 1937 the name of the corporation was changed

to Honolulu Oil Corporation. Both of said corporations will be referred to as "Honolulu." (R. 31.)

On August 31, 1936, Honolulu liquidated three wholly owned subsidiary corporations, hereinafter in this Summary Statement referred to as "Subsidiaries," and took over all their assets and assumed their liabilities. The liquidation of said wholly owned Subsidiaries was carried out under the nontaxable provisions of section 112(b)(6) of the Revenue Act of 1936. (Appendix, pp. ii-iv.) (R. 33.) One of said wholly owned Subsidiaries was California Exploration Company, Inc., which corporation resulted from the consolidation in 1934 of two prior wholly owned subsidiary corporations of Honolulu which had been formed by Honolulu to acquire and develop prospective oil properties in the States of Wyoming and Texas. (R. 31-32.) Another of said wholly owned Subsidiaries was Sea Cliff Development Company, Ltd., which had been formed by Honolulu to acquire and develop prospective oil properties in Ventura County, California. The third wholly owned subsidiary, Processco, Limited, was formed by Honolulu primarily to acquire and develop patents relating to the processing of crude petroleum. (R. 32.)

Each of said wholly owned Subsidiaries sustained operating losses during the period from their incorporation to their dissolution. In the case of California Exploration Company, Inc., both its predecessors also sustained operating losses up to the date of their consolidation in 1934, which operating deficits were carried forward on to the books of the consoli-

dated company, California Exploration Company, Inc. The total operating deficits of said three wholly owned Subsidiaries as of the date of their liquidation on August 31, 1936, was \$1,205,451.61. (R. 36-37.)

Upon the liquidation of said wholly owned Subsidiaries and the transfer of all their assets to Honolulu, Honolulu realized a loss of \$1,225,908.63.¹ (R. 33.)

In 1936, the year involved in this petition, Honolulu paid cash distributions to its stockholders in the amount of \$1.00 on each of its outstanding 937,743 shares of capital stock, or a total cash distribution of \$937,743. (R. 38.) On January 1, 1936, Honolulu had available for dividends accumulated earnings or profits in the amount of \$139,631.26. Honolulu's earnings or profits during the calendar year 1936 amounted to the sum of \$931,553.82 before deducting any portion of said loss realized upon the liquidation of said Subsidiaries in the amount of \$1,225,908.63, or before deducting the total operating deficits of said Subsidiaries in the amount of \$1,205,451.61. (R. 38.)

Since Honolulu admittedly realized a loss of \$1,225,908.63 upon the liquidation of the Subsidiaries in 1936 and since this loss was sufficient to eliminate not only Honolulu's normal 1936 earnings of \$931,553.82, but also the earnings as of the beginning of the year in the amount of \$139,631.26, it follows that the divi-

¹The difference between this loss of \$1,225,908.63 and the total operating deficits of the Subsidiaries in the amount of \$1,205,451.61, referred to in the previous paragraph, is due to a payment of \$20,457.02 made by Honolulu to third parties for a contingent interest in the capital stock of Processeo, Limited. (R. 34.)

dends paid by Honolulu in 1936 were actually distributions of capital and not income to the recipients, except to the extent that effect must be given to the accumulated earnings as of January 1, 1936.² The same result would follow if the earnings of Honolulu available for dividends were reduced by the operating deficits of the Subsidiaries as of the date of their liquidation.

QUESTIONS PRESENTED.

The fundamental question for decision in this petition is whether the operating deficits of said wholly owned subsidiaries as of the date of their liquidation in 1936, in the aggregate amount of \$1,205,451.61, were inherited by Honolulu upon the nontaxable liquidation of said subsidiaries in accordance with the principle of *Commissioner v. Sansome*, 60 F. (2d) 931 (C.C.A. 2), certiorari denied, 287 U.S. 667, thus resulting in a reduction of the earnings of Honolulu available for dividends; or, in the alternative, whether the loss realized by Honolulu upon the liquidation of said subsidiaries in 1936, in the amount of \$1,225,908.63, reduced the earnings of Honolulu available for dividends.

Petitioner's principal contention is that the operating deficits of the wholly owned subsidiaries were in-

²It would appear that the accumulated earnings as of January 1, 1936, in the amount of \$139,631.26 should be reduced by the loss for the year 1936 prorated on a daily basis to March 14, 1936, the date of the payment of the first dividend, and that the remainder of said accumulated earnings would then be available for the payment of that dividend. The remaining three dividends in 1936 were entirely paid out of capital.

herited by Honolulu upon the nontaxable liquidation of said subsidiaries. In this connection, petitioner asserts that the Court below erred in the following respects:

(1) In deciding that the operating deficits of the subsidiary corporations as of the date of their liquidation in 1936 did not diminish the earnings or profits of Honolulu which were otherwise available for dividends.

(2) In assuming that it was necessary for petitioner to prove what portion of the deficits of the subsidiaries occurred in the tax year 1936.

In the alternative, petitioner contends that the loss actually realized by Honolulu upon the liquidation of the subsidiaries in 1936 reduced the earnings of Honolulu available for dividends, that section 501 of the Second Revenue Act of 1940 (Appendix, pp. vi-viii), if applied to the facts of this case, violates the provisions of the Sixteenth Amendment to the Constitution of the United States, and that the retroactive application of this section for a period of more than four years is a violation of the due process clause of the Fifth Amendment to the Constitution of the United States. In connection with this alternative contention petitioner asserts that the Court below erred in the following respects:

(1) In dismissing this alternative contention without consideration on the ground that there has been no showing that any of the loss sustained by Honolulu upon the liquidation of its subsidiaries was incurred in the tax year 1936. It is stipulated that the sub-

sidiaries were liquidated on August 31, 1936, and that upon said liquidation Honolulu realized a loss of \$1,225,908.63, the entire amount of the loss in question. (R. 33.)

(2) In stating that it is admitted that \$931,553.82 earnings or profits were made in 1936 by Honolulu. It is stipulated that these are the earnings before deducting the loss of \$1,225,908.63 realized in 1936 upon the liquidation of the subsidiaries. (R. 38.)

REASONS FOR GRANTING THE PETITION.

1. The Circuit Court of Appeals for the Ninth Circuit has decided an important question of Federal law which has not been but should be settled by this Court. This decision, although not directly in conflict with the decision of the Circuit Court of Appeals for the Second Circuit in *Commissioner v. Sansome*, 60 F. (2d) 931 (C.C.A. 2, 1932), certiorari denied, 287 U.S. 667, does conflict with the principle upon which the decision in that case is based. That principle is that corporate reorganizations which result in no recognized gain or loss under the reorganization section of the Revenue Acts (section 112 of the Revenue Act of 1936 and of the Internal Revenue Code) do not interrupt the company's life as a continued venture under the dividend section of the Revenue Acts (section 115 of the Revenue Act of 1936 and of the Internal Revenue Code) with the result that the earnings or profits of the transferor are inherited by the transferee.

The recent decision of this Court in *Commissioner v. Wheeler*, U.S. (March 26, 1945), makes it of general importance in the administration of the revenue laws for this Court to determine whether it will give its sanction to the doctrine of the *Sansome* case, and decide further that that doctrine is applicable to operating deficits as well as earnings, or whether this Court will determine that its decision in the *Wheeler* case is not applicable to nontaxable liquidations of subsidiary corporations. In the *Wheeler* case this Court approved as valid a Treasury Regulation providing that gains and losses are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under section 112. (This regulation has now been enacted into law by section 501 of the Second Revenue Act of 1940.) (Appendix, pp. vi-viii.) The basis of the decision in the *Wheeler* case is that recognition of gain or loss for tax purposes is deferred and that when taken account of for tax purposes at a later time the effect upon earnings or profits available for dividends can at that time likewise be taken into account. But this is not true with respect to nontaxable liquidations of subsidiary corporations, where the recognition of gain or loss is *not* merely deferred—it is *never* entirely recognized for tax purposes,³ and may, as in the instant case, receive no recognition whatever. This is so because the basis section of the statute (section 113(a)(15) of the Revenue Act of 1936 and of the

³This is true unless the subsidiary's operations have resulted in neither realized gain nor realized loss. See discussion and examples *infra*, pages 37 to 45.

Internal Revenue Code (Appendix, p. v)) provides that the basis of the property received by the parent from the subsidiary remains the same as it was in the hands of the subsidiary. If this section had provided that the basis to the parent of the property received from the subsidiary should be the same as the basis to the parent of the subsidiary's *stock*, then the recognition of gain or loss to the parent would have been deferred and would be entirely realized later upon disposition by the parent of the subsidiary's property, and at that time the earnings or profits of the parent would reflect the proper adjustment.⁴ But since gain or loss to the parent is never entirely recognized, the proper adjustment to the earnings or profits of the parent, if it is ever to be made, must be made at the time of actual realization upon liquidation. This can be accomplished either by approving the doctrine of the *Sansome* case, including therein operating deficits as well as earnings, or by a decision that the regulation approved in the *Wheeler* case is unreasonable and invalid and section 501 of the Second Revenue Act of 1940 unconstitutional when applied to the nontaxable liquidation of subsidiary corporations.

2. If all stockholders of Honolulu have filed claims for the three years, 1936, 1937 and 1938, the total refund claims which will be controlled by the decision in this case will exceed 6600. Each of the stockholders was advised that these test cases would be filed and

⁴But such a provision would result in double taxation, the parent paying a tax on gains already taxed to the subsidiary. See Brief, *infra*, page 37.

all expense in connection therewith borne by Honolulu, they were each furnished with the complete form of refund claim to be filed, and they were each furnished with the form required to enter into an agreement with the Commissioner to abide by the result of these cases. The distributions of capital taxed as income to the stockholders of Honolulu in the years 1936, 1937 and 1938 are equal to the loss realized by Honolulu upon the liquidation of its subsidiaries, namely, \$1,225,908.63.

3. The Court below dismissed without consideration petitioner's alternative contention that section 501 of the Second Revenue Act of 1940 is unconstitutional as applied to the facts of this case, basing said failure to consider on the ground that petitioner failed to prove that the loss on the liquidation of the subsidiaries was incurred in 1936. This fact was stipulated. Petition for rehearing was based on this ground, amongst others, and was denied.

Wherefore, it is respectfully submitted that this petition for writ of certiorari to review the judgment of the Circuit Court of Appeals for the Ninth Circuit should be granted.

Dated, San Francisco, California,
May 16, 1945.

LEON DE FREMERY,
Attorney for Petitioner.

CERTIFICATE OF COUNSEL.

I hereby certify that I am attorney for petitioner herein and that in my judgment the foregoing petition for a writ of certiorari is well founded and that it is not interposed for delay.

Dated, San Francisco, California,
May 16, 1945.

LEON DE FREMERY,
Attorney for Petitioner.

